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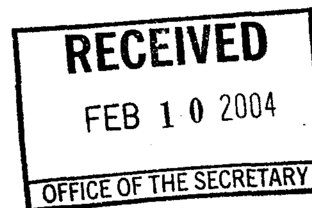


Goldman Sachs

February 9, 2004

Securities and Exchange Commission,
450 Fifth Street, N.W.,
Washington, DC 20549-0609

Attention: Mr. Jonathan G. Katz, Secretary

Re: Alternative Net Capital Requirements for Broker-Dealers that are part of Consolidated Supervised Entities -- File No. S7-21-03

Dear Mr. Katz,

We would like to take this opportunity to comment on the proposed Alternative Net Capital Requirements for Broker Dealers that are part of Consolidated Supervised Entities. We commend the Commission for the efforts it has made to develop a regulatory framework that will contribute to the safety and soundness of financial institutions and markets by aligning regulatory capital requirements more closely with well-developed internal risk management practices. These approaches have the further merit of building on the extensive experience that has been acquired by the Commission over the last five years in the supervision of "OTC Derivatives Dealers".

We have a number of comments on the proposed rules, as well as several responses to some of the questions raised by the Commission in the proposal. Prior to discussing our comments and responses, we would like to raise one additional issue.

As the Commission is well aware, the European Union has adopted the Financial Groups Directive which will apply to U.S. securities firms operating in the E.U. as of January 1, 2005. Among the provisions of this Directive are requirements that U.S. securities firms operating in the E.U. must either (1) be subject to U.S. consolidated supervision deemed by the E.U. to be equivalent to the consolidated supervision requirements of the Financial Groups Directive, or (2) otherwise comply with the Directive. It will take significant effort and time to prepare to comply with either the CSE requirements or otherwise with the requirements of the Financial Groups Directive.

On the assumption that the E.U. will determine that the proposed role of the SEC with respect to CSEs will satisfy the Financial Directive's equivalence test, it is important that the SEC adopt the CSE rules early enough to permit the CSEs to implement them for financial years commencing on or after January 1, 2005.

I. Capital Definition

A. Eligibility of Senior Unsecured Debt

We do not believe that it should be necessary for long-term debt to contain a subordination feature in order to qualify as supplemental regulatory capital ("qualifying debt"). Accordingly, references to "subordinated debt" in section (a)(1)(iii)(B) of Appendix G should be replaced by the words "senior, unsecured long-term debt" ("senior debt"). In our experience, both the markets and rating agencies have historically recognized that senior debt provides essentially the same funding and liquidity benefits as subordinated debt. Senior debt is accepted in the market as providing stable funding over a long period of time and thereby provides assurance to short-term creditors, counterparties and customers. We believe the regulatory capital requirements should generally be consistent with this economic and market practice.

Subordination is unnecessary in the context of qualifying debt for the following reasons:

a) Subordination provides no additional protection from insolvency or bankruptcy as compared to senior debt. If a CSE's equity capital is reduced to the extent that its liabilities exceed its assets, it will in most cases be deemed to be legally insolvent, regardless of whether its remaining capital base includes subordinated debt or is exclusively comprised of senior debt.

b) Subordination provides no additional funding or liquidity benefits as compared to senior debt of the same tenor and with otherwise identical provisions. This is evidenced by the fact that rating agencies and credit analysts typically make no distinction between subordinated debt and senior debt when calculating a firm's long-term capital. 100% of both types of debt security are included in this computation.

c) Subordinated debt issued at the parent-level does not provide subordinated protection at the operating entity level. In order to meet the regulatory capital needs of operating subsidiaries, it has long been the practice of securities firms to raise senior debt at the parent level and to downstream the proceeds to the regulated operating subsidiaries as subordinated debt. As a result, the parent-level senior debt becomes structurally subordinated to the claims of customers, trading counterparties and other senior creditors of the operating entities. This effectively

subordinates the parent-level senior debt to the holders of the senior debt and other creditors of the operating subsidiary.

An alternative to excluding senior debt from the definition of qualifying debt would be to permit senior debt to be included in the definition, but require that the minimum remaining maturity requirement for such debt that meets the definition be increased from one year to two years. Current Federal Reserve capital rules permit a remaining maturity of one year, and we do not believe that increasing the minimum maturity from one year to two years is necessary. However, it would be more consistent with the objective of providing stable funding and assurances to creditors, and would result in a more reasonable and practical outcome, than the proposed subordination requirement.

If the Commission does not modify the proposal to eliminate the subordination requirement, then it is important that there be a "grandfathering" provision for existing senior debt. Senior debt that is outstanding at the time these rules become effective should be treated as qualifying debt until its maturity, and would have to comply with all of the other capital eligibility requirements and limitations, including the one-year minimum remaining maturity requirement.

Unlike commercial banking firms, to date, investment banking firms have not been required to issue subordinated long-term debt in order to satisfy regulatory capital requirements. These firms have funded their capital requirements with billions of dollars of outstanding senior debt, as there was no reason to issue more expensive subordinated debt. If the definition of qualifying debt excludes senior debt, the investment banking firms will be faced with the prospect of raising significant amounts of subordinated debt over a relatively short time frame. Depending on market conditions, the overall capital requirements of the investment banks and the terms of any redemption provisions in the outstanding senior debt (a very significant portion of such debt is not callable or callable only at a premium), investment banks could be faced with very significant financing and refinancing costs unless a grandfathering provision is included in the final rule. As commercial banks have been required to raise subordinated debt to meet existing capital requirements, investment banks could be put at competitive disadvantage in terms of their cost of capital for a substantial period of time.

B. Eligibility of Deferred Tax Assets

Deferred tax assets that firms can reasonably expect to realize within a short period of time should not be deducted from shareholders' equity in order to determine "Allowable Capital". We therefore recommend that section (a)(1)(i) of Appendix G be amended to exclude from the deduction those deferred tax assets that the CSE can reasonably expect to realize within one year. Specifically, Appendix G should be amended to require the deduction of deferred tax assets, except for:

(a) those deferred tax assets whose realization is not dependent on future taxable income (for example, because they can be carried back to offset prior-year taxable income); and

(b) those deferred-tax assets that the CSE is expected to realize within one year due to future, projected taxable income.

C. Hybrid Capital Instruments

Appendix G should be amended to allow for the inclusion within Tier 1 capital of certain hybrid capital instruments, including Trust Preferred Securities.

Hybrid capital instruments provide firms with significant economic and liquidity protection, and various regulators and certain major rating agencies recognize and include these instruments (up to certain limits) in their computation of a firm's "core capital". It is estimated that there are in excess of $90 billion of such hybrid capital instruments outstanding. Accordingly, CSEs would be at a significant competitive disadvantage if, unlike certain other regulated institutions, they were unable to utilize this lower cost alternative to meet a portion of their Tier 1 capital requirements.

II. Trading Book / Basel II Proposals

Under the current Basel II proposal, the conditions for positions in financial instruments and commodities ("financial positions") to receive "trading book treatment" include, among other qualitative criteria, a requirement that they be held with trading intent and be marked to market. The determination as to whether financial positions should be afforded trading book treatment should be based upon their meeting such criteria. All financial positions which meet these criteria, including funded loans, should receive trading book treatment.

We note that further refinement of the Basel II proposals is essential in a number of areas of particular importance to the businesses of investment banks. Such areas include clarification of the trading book definition, maturity adjustment factors and counterparty credit exposures. We note that we, and other investment banks, have previously submitted comments upon these issues to the Basel Committee. We understand that the Basel Committee, in co-ordination with the International Organization of Securities Commissions (IOSCO), plans to undertake a review of certain trading book issues contained within the current Basel II proposals. We strongly support this initiative and the Commission's participation in these discussions.

III. Market Risk

A. Timing of VaR Implementation at the Broker-Dealer level

We support the proposed use of a VaR-based methodology to determine capital requirements for market risk at both the holding company and the broker-dealer level. However, we think that the use of VaR models at the broker-dealer level should not be phased-in, but should be adopted from the outset. If the use of VaR models is phased-in, then the methodology for computing capital requirements for the same positions would be different at the broker-dealer and holding company level (where there is no phasing-in of VaR models). This divergence of capital requirements has both conceptual and practical implications: for example, an individual trading desk's risk may be hedged by a variety of financial instruments, some of which will be eligible for VaR treatment at the broker-dealer level, and some not; this situation would give rise to inconsistent capital treatment with respect to the same financial instruments, both within the broker-dealer and between the broker-dealer and the holding company.

Specifically, paragraph (c) of Appendix E should be amended to allow simultaneous implementation of VaR models (assuming appropriate documentation and procedures are in place) to determine capital requirements for all inventory types. If the Commission should determine that both it and broker-dealers need additional experience in the use of the VaR-based methodology to determine capital requirements, the Commission could consider supplementing requirements computed on the basis of these models with a standard allowance, to be diminished as experience is gained.

B. Eligibility of Certain Products for VaR Treatment

Section (c)(2) of Appendix E requires broker-dealers to obtain specific authorization from the Commission in order to use VaR models for securities that have no ready market or are below investment grade. The Commission, when determining whether such securities are eligible for VaR treatment, should adopt a "rule of reason" approach by focusing upon whether the broker-dealer can demonstrate that its models materially capture the risks associated with these products, including through the use of appropriate proxies.

C. Scenario Analysis

Section (c)(5) of Appendix E of the CSE proposal permits the applicant to request approval for the use of scenario analysis to compute its market risk capital charge for certain positions. Specifically, sub-paragraph (ii) of this section requires a scenario qualifying for use to include:

> *"a range of adverse movements of risk factors, prices, or spreads that moved by the greatest amounts over the past 5 years or a 3 standard deviation movement in those risk factors, prices, or spreads over a 10 day period."*

This requirement would significantly restrict the ability of CSEs to use scenario analysis when historical data is limited. Accordingly, the wording should be amended as follows:

> *"a range of adverse movements in relevant risk factors, prices or spreads designed to represent a negative move greater than, or equal to the worst 10 day move over four years (i.e. a 2 week 99% move). Where sufficient data does not exist, reasonable proxies may be used to support the stress test."*

IV. Credit Risk

A. Credit Risk on OTC Derivatives

We believe that capital requirements for credit risk on OTC derivatives should ultimately be determined using a model-based methodology that recognizes the risk-mitigating effects of offsetting positions across the portfolio of counterparties, is integral to a firm's risk-management practices and has proved its value and reliability over a period of time. The Commission's model-based "maximum potential exposure" ("MPE") methodology is an important step towards achieving this objective.

We note, however, that a particular aspect of the MPE methodology is more onerous than the Basel Committee's target of a capital requirement consistent with a 0.1% probability of default. More specifically, the Commission's proposal combines a 0.1% likelihood Probability of Default with a 1.0% likelihood Exposure At Default, thereby producing a capital requirement consistent with a 0.001% scenario probability.

It is our understanding that the capital requirement for credit risk on OTC derivatives is among the issues to be reconsidered by the joint Basel Committee / IOSCO review of trading book issues. We strongly support the Commission's participation in this initiative. We would hope that a risk-sensitive methodology, incorporating the risk mitigating effects of offsetting positions across the portfolio of counterparties, will emerge from this review.

B. Credit Risk Weights

The CSE proposal requests comment on whether Appendices E and G should include an additional method of calculating credit risk weights, based on internal calculations, including the use of internal credit ratings. We believe that such a methodology should be permitted. Such methodology is consistent with the Basel II "Advanced Internal-Ratings Based" ("Advanced IRB") methodology, and also with the Federal Reserve Board's implementing proposals contained in their recently-published "Advanced Notice of Proposed Rulemaking".

The proposal also requests comment on the appropriateness of a standard 75% "Loss Given Default" factor in the determination of credit risk weights. The use of a fixed LGD factor is inconsistent with the Basel II Advanced IRB methodology. Further, we note that actual loss experiences and external data available from multiple sources over significant periods of time demonstrate that the 75% LGD factor is overly conservative. Imposing a 75% LGD factor would have a significant impact on capital requirements, as the LGD factor has a linear effect on credit risk weights.

C. Portfolio Margining

The Commission, in conjunction with the New York Stock Exchange, should revise the current margining requirements of NYSE Rule 431. Currently, margining requirements under Rule 431 are primarily based upon a fixed, haircut-based approach. Rule 431 should be amended to permit broker-dealers to adopt a broad, proprietary, model-based portfolio margin methodology which recognizes the risk-mitigating effects of offsetting positions across a portfolio. Adoption of a broad, proprietary, model-based portfolio margining methodology would permit broker-dealers to adopt risk-based margin requirements in a manner consistent with the CSE and Basel II proposals' movement towards a more risk-sensitive framework.

D. Back-testing of MPE Models

Under section (e)(1)(iv) of Appendix E, firms are required to conduct back-testing of the exposure model used to calculate MPE by comparing, for a sample of counterparties, the daily change in its current exposure ("CE") based on the end of the previous day's positions with the corresponding MPE for the counterparty generated by the exposure model. However, since the MPE is based on a 1-year time horizon, it is inconsistent to compare it with a 1-day change in CE.

While we consider that changes in CE should be compared to an MPE result based on the same time-horizon, it is impractical to compare a 1-year MPE to a 1-year CE, since this would generate too few data points to draw meaningful statistical conclusions regarding model integrity.

To strengthen and improve this back-testing requirement, we suggest the following methodology: for the purpose of the back-testing exercise only, for each counterparty in the sample, the MPE time-horizon would be reduced to 5 business days and compared to the difference between the CE at the beginning and end of each 5-day period (excluding any new trades booked during that period). By so doing, a sufficient number of data points would be collected by the end of a year to constitute a reasonable testing of the model.

V. VaR Models

A. Data Requirements

Under (e)(2)(iii) of appendix E, firms are required to use VaR models that are estimated using at least one year of historical data. In addition, the historical data set must include periods of market stress and must be updated at least monthly or whenever market price or volatility changes would warrant reassessment. Firstly, periods of one year (or even longer) will frequently not contain periods of market stress. Accordingly, we recommend that this requirement be eliminated. Secondly, while we agree that firms should be able to use historically-based VaR models, we recommend that the Commission allow the use of VaR models based on information implied from market prices for 1-year horizon potential exposure calculations.

Implied potential exposure models, since they are forward looking in nature and incorporate market expectations, can have important advantages. As an example, the market may have incorporated expectations of exchange rate turbulence into implied volatilities, even though that turbulence is not present in the historical data. A potential exposure model using implied volatilities would capture this risk. Because of these advantages, potential exposure models that use implied parameters are in widespread use in the financial industry. We therefore would recommend that firms have the option to use implied potential exposure models for 1-year MPE calculations.

B. Approval Process

When reviewing a CSE's risk-based models, we recommend that the Commission give consideration to the models already reviewed and approved by other regulatory authorities. We further recommend that, in consideration of the 2005 effective date of the EU Financial Groups Directive discussed above, the Commission should consider provisional approval of models, conditional on the firm providing all required documentation and no finding of material deficiencies. We recognize that provisional model approval would ultimately need to be replaced with explicit approval and that, in the interim, the Commission may need to consider the use of increased multipliers or other adjustments.

VI. Operational Risk

Appendix G requires CSEs to compute an allowance for operational risk, to be determined "consistent with appropriate standards published by the Basel Committee on Banking Supervision, as modified from time to time". We note that the Basel Committee's "Basic" and "Standardized" Approaches are not risk-based and do not follow risk-management practices. In the case of the Standardized Approach, the multipliers (or "Betas") are unduly onerous for many of the business lines of large investment banks and, to our knowledge, have not been supported by industry data. We anticipate that the Basel Committee's Advanced Measurement Approach ("AMA") will

yield a more appropriate capital requirement that is sensitive to our risk management framework.

We note, however, that the Basel Committee has not yet finalized the AMA methodology, and there is ongoing debate both about the calibration of the capital requirement and the indicators that would form the basis for its determination. Given the limited history of data collection across the industry and the potential risk-weighting attributed to certain low-frequency/high-impact loss events, the 99.9% confidence interval should be replaced with a less prescriptive standard which would allow firms flexibility in determining a confidence level that is appropriate, given the type and quality of the AMA risk measurement system that is in place. We would welcome the opportunity to work with the Commission to develop a set of common indicators that would be appropriate for groups containing substantial investment banking activities and that would serve as a basis for capital charges for operational risk in CSEs.

VII. Reporting Issues

A. Filing of Reports

Section (b)(2) of Appendix G requires certain reports to be filed with the Commission within 35 days of each quarter-end, including a firm's year-end. We recommend that the requirement for the quarter-end coinciding with the firm's fiscal year-end be amended to align with the dates by which public companies are required to submit their annual report on Form 10-K.

Additionally, we note that the reference in sub-paragraph (b)(1)(ii) of Appendix G to "notes to the financial statements" which must be filed with the monthly consolidated balance sheet and income statement could be understood to refer to the comprehensive set of notes that form part of a firm's accounts. We believe that a commentary explaining significant highlights and month-to-month fluctuations would be of more value to the Commission and more consistent with internal management practices. Accordingly, the relevant section of Appendix G should be amended to read "(ii) A consolidating balance sheet and income statement (including a written commentary on significant highlights of the financial statements)."

B. Internal Audit Reporting Requirements

You have requested comment on whether Rule 15c3-4 should be amended to require that results of periodic reviews conducted by an internal auditor be reported in writing to the Board of Directors. We think that it would be more appropriate and consistent with recent changes in corporate governance laws for the results of internal audit reviews to be provided to the Audit Committee of the Board of Directors. During the course of a year, a large number of audit reviews are conducted at a major broker-

dealer. The Audit Committee should be required to review the significant audit findings, not all findings, in order to ensure that critical control issues are given adequate focus.

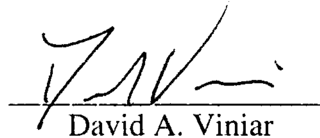
VIII. Timeframe for Implementation of Basel II

We note that the CSE Proposals make reference to the "standards published by the Basel Committee on Banking Supervision, as modified from time to time". Since U.S. investment banks do not currently apply Basel I on a consolidated basis, we think that CSEs should be permitted to apply the Basel II standards on an accelerated basis, provided that the Accord is finalized, even if it is not yet implemented. In addition, since we understand that the joint Basel Committee/IOSCO review of certain trading book issues may result in further modifications to Basel II after its initial publication, we believe that the proposal should be modified to permit CSEs to apply such modifications, if they have been finalized, even if they have not yet implemented.

* * *

We would be happy to discuss with the Commission or its staff any questions that you may have with respect to the comments made in this letter and we re-affirm our willingness to continue to work with the Commission and its staff in its efforts to finalize the rules. We ask that you direct any questions that you may have to Mark Holloway at (212) 902 1360 or Jay Ryan at (212) 902 7073.

Very truly yours,



David A. Viniar

cc:
The Honorable William H. Donaldson, Chairman, Securities and Exchange Commission

Annette L. Nazareth, Director, Division of Market Regulation, Securities and Exchange Commission

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